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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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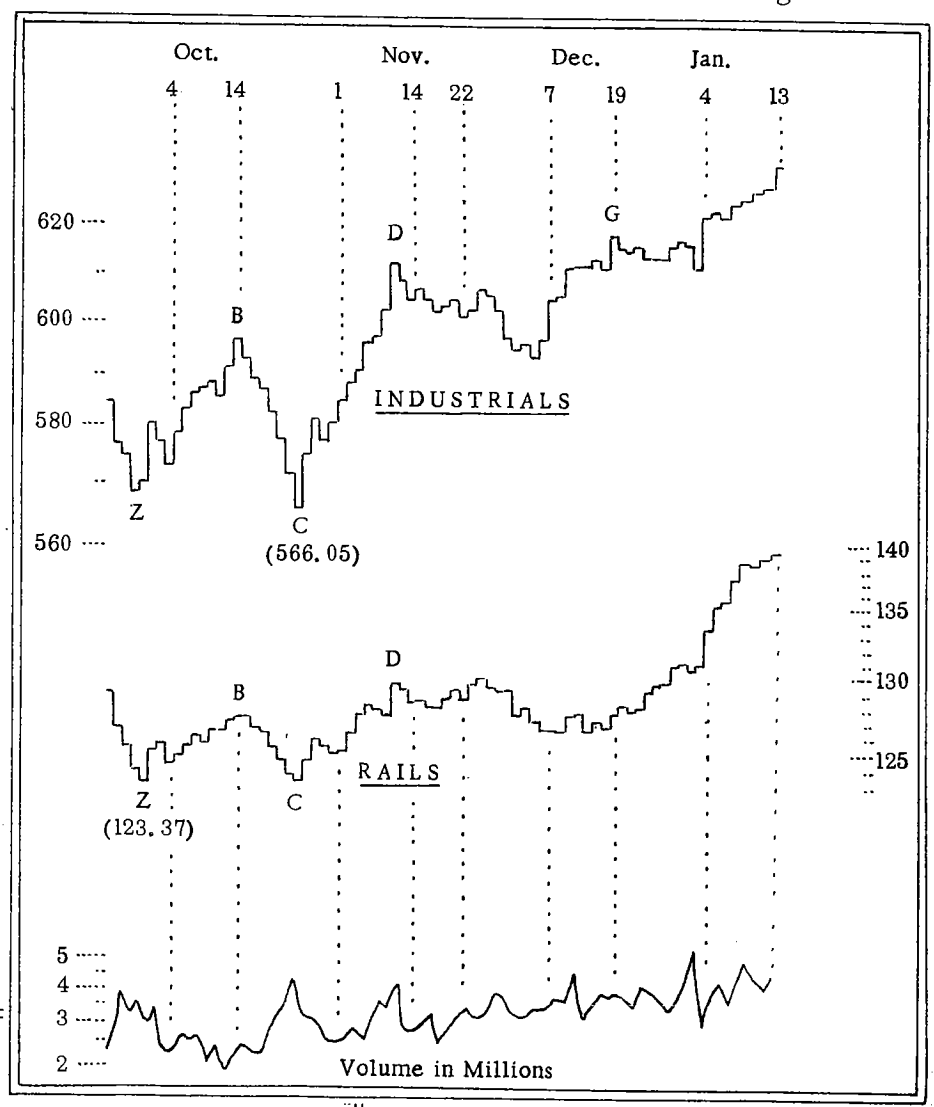
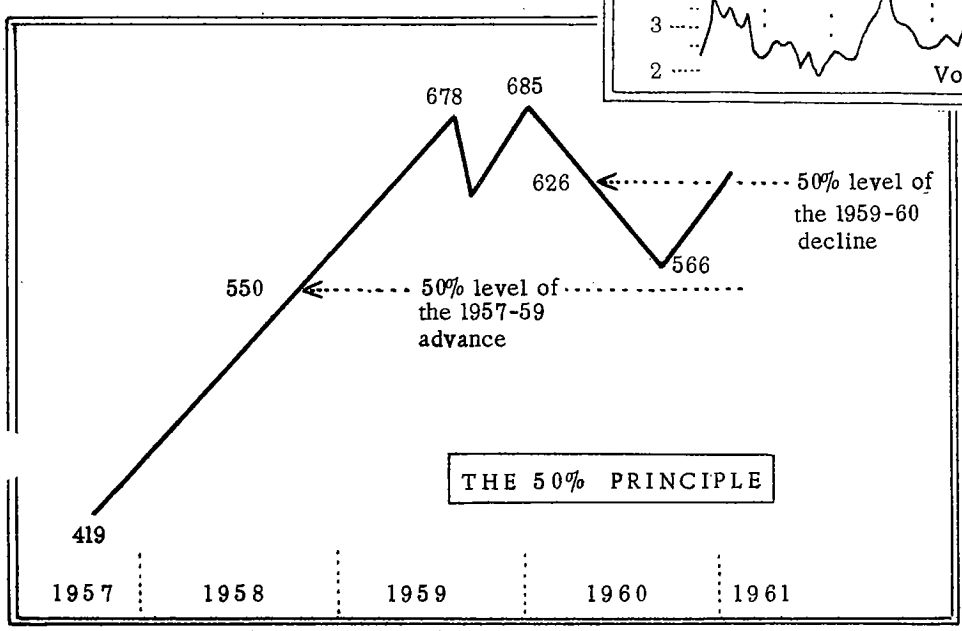
January 16, 1961 Number 130

PRICE MOVEMENTS The third primary leg of the bear market erased 90 points (656.42 to 566.05) from the Industrial Average, 23 points (146.56 to 123.37) from Rails. So far the correction has succeeded in retracing 74% of Industrial losses, 70% of Rail losses. The move has lasted over three months which means that the reaction has now exceeded normal expectations in both duration and extent.

(1) If the last secondary highs (Industrials 656.42, Rails 146.56) are bettered, or (2) if the advance since Z-C is fully corrected, and a new advance takes the Averages above whatever highs are now being established, then a great many observers will proclaim a new bull market. As outlined in recent Letters, I would be most skeptical of such a classification.





50% PRINCIPLE In September, 1960, subscribers were sent a special study on Dow's 50% Principle. In the light of the market action since then, it might be well to review the implications of the 50% Principle.

The chart shows the primary bull swing of 1957-59, a swing which advanced the Industrials from 419 (October, 1957) to 678 (August, 1959). The first leg of the bear market followed the August, 1959 high, taking

Industrials back to 616. On the first reaction (upwards) which began in September, 1959, Industrials touched a new high of 685 (January, 1960). This new high was not confirmed by Rails. Following the January highs both Averages turned down, and by October, 1960, the bear market had taken Industrials to a low of 566.

Note on the chart, however, that the 566 low of October, 1960, held approximately 16 points above the halfway or 50% level (550) of the entire 1957-59 advance. The fact that Industrials did not break below the 50% level of the preceding primary swing was a hopeful indication under the 50% Principle (see Letter 126).

Since the establishment of the 566 low the Averages have rallied persistently, and it is particularly interesting to note that Industrials have now exceeded the halfway level (626) of the entire drop from 685 to 566 (see chart). Under the 50% Principle (forgetting all fundamentals and all possible pros and cons connected with such a move), the stage is being set for a possible "New Era" type "blow-off" of a variety not seen since 1930.

The following statement is strictly my own conjecture, it is theoretical and is not intended as investment advice: if on the next decline Industrials can hold above 566 (and much more importantly, if they can hold above the 30 week moving average which is now at 609.54), and if on the subsequent advance Industrials can hurdle whatever high point is now being established, there is a chance that the Industrial Average will approach the old high of 685. This would be in accordance with Rule 1 as stated on the second page of the special study of Dow's 50% Principle.

This writer has no "trade secrets" or "inside information" concerning the market. I attempt to provide subscribers with whatever information may arise in the course of my studies. It is my opinion that such a move (a return to the highs) would be a false move as far as an economic prediction is concerned (the great reaction of 1930 was exactly this), and it is also my opinion that the aftermath of a surge to the highs would be a general market collapse.

The question then arises: if it appears that such a movement is developing, should the reader buy stocks during the next decline or at the beginning of the subsequent advance. I can only say that buying on the basis of a possible New Era surge is speculating on psychology, not buying for investment. The majority of readers of these Letters tend to be knowledgeable and sophisticated investors or traders. Hamilton once said that enough inside information can break any man on Wall Street. He might have added that enough market advice can break any man on Wall Street or any place else.

QUESTION: Suppose the market were to continue climbing towards the highs with no correction?

ANSWER: That would even scare Keith Funston, but anything is possible (particularly with odd-lots showing increased caution again).

A LETTER Occasionally I receive a letter containing material which I believe is important enough to bring to the attention of subscribers. The following, from Mr. B. K. Shahrok, Ph.D., Berkely, California, is such a letter: "In your Letter 129, quoting Mr. B. Baekeland, you bring up the question of 'panic' and the possibility that such will not be seen in this market. I should like to bring up a few points which I think are in contradiction with this viewpoint.

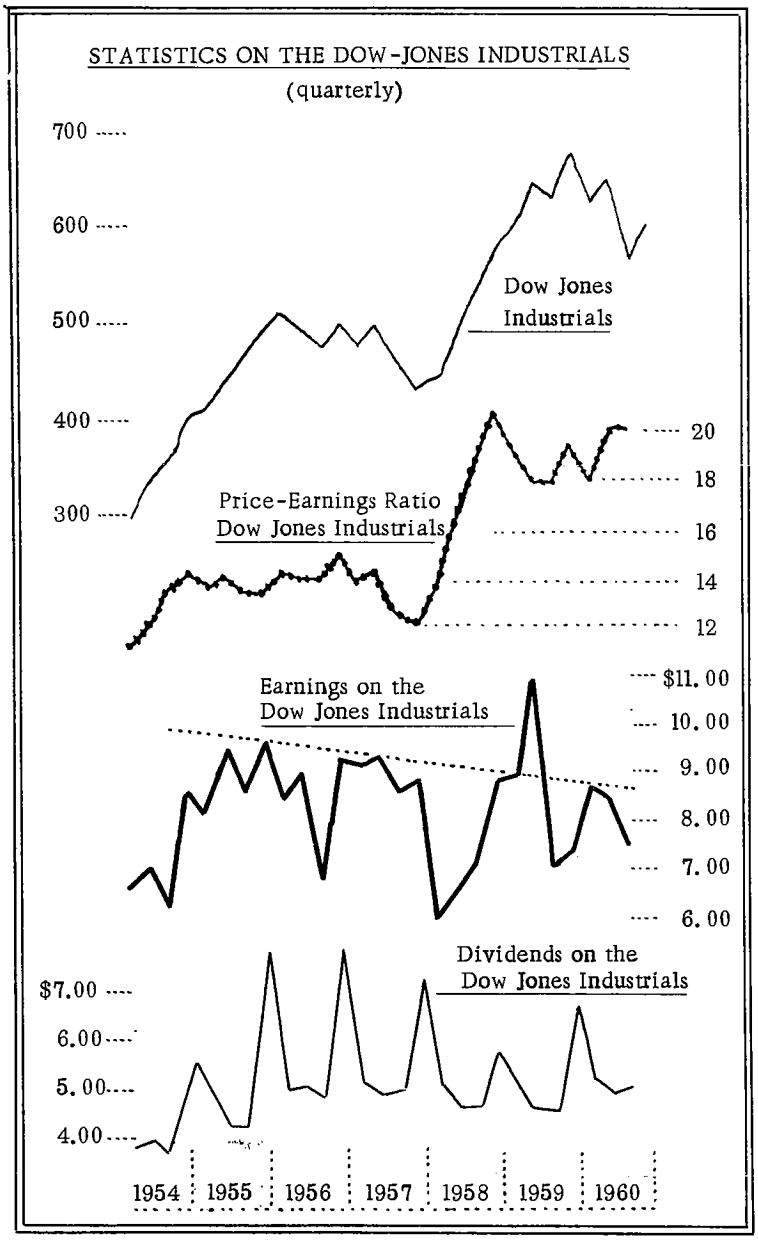
Panic is usually caused when the public as well as a good portion of professionals become disillusioned. Disillusionment follows the abandonment of hopes of market recovery. Abandonment of hope comes after failure of the last effort in a struggle. We are now in a stage wherein people have had a shock, but they continue to anticipate plenty of opportunity for a market advance. There must be at least one good effort to reach the peak of 685. The failure of this effort should create conditions which will end in panic selling.

It seems to me that the present secondary reaction is not sufficiently convincing to arouse the enthusiasm of a good segment of investors. As a result we shall see a downward move in the near future. Now if this downward movement fails to reach the previous low of 566, and the trend turns upward, then superficially a bull signal will have been given (which I believe will be a false signal). This will be especially true if the rails follow the same pattern. Taking into consideration that more than half of the investors and traders are some sort of chartists, and that most of them recall that they missed the upturn signal in 1958, then the obvious conclusion would be to jump into the market with full force. This impact should push the average to 685 and quite possibly beyond this point.

Now I should consider this move to be the last struggle which will fail and which shall end in panic selling."

TRENDS AND VALUES The accompanying chart tells an interesting story. Perhaps the most important part of that story is the fact that the earnings on the D-J Industrials hit a peak in 1955 and have been in a downtrend ever since. The peak price of the D-J Industrials in 1955 was 487, it was 520 in 1956 and 521 in 1957. Yet against a declining earnings trend the Industrials surged in 1958-59 to establish all-time highs of 678 (August, 1959), 685 (January, 1960). What actually occurred is clear enough on the chart. The third phase bull market advance of 1958-59 was a price earnings boom, a boom which reflected hopes rather than facts.

The question then becomes one of how long Industrials can continue to hold or rise against indifferent earnings? Or stated another way the question becomes: will earnings rise in the future or will the Industrial Average decline? The high point for price-earnings ratios in 1929 was 19.1, in 1937 it was 16.9 and in 1946 it was 15.6. Certainly a market rise from current levels would take stocks to a peak in overvaluation seldom (if ever) seen in market history.



AN EXTRA "...The less a man knows of the past and present the more unreliable must his judgment of the future prove." (Freud)

I have reason to believe that these Letters are read by a large percentage of today's serious students of the price movement. For this reason I have included a seldom seen "collector's item" with this mailing. It is a chart of the original Dow Jones Averages (weekly) from 1885 to 1896. As far as I know this is the only authentic record of the price movement during that fascinating period.

The pattern begins with what might be termed the bull markets of 1885-86 and 1888-90. These periods coincide with the Presidential terms of Cleveland (Democrat, 1885-88, 1893-96) and Harrison (Republican, 1889-92). The upturn in 1885 followed what the great historian Alfred Dana Noyes called "...an accurate and very alarming convulsion; let up to by the commercial depression, the flight of foreign capital, and the disordered Treasury finances, and immediately precipitated by the discovery of vast financial frauds."

As seen on the chart, the market of 1885 soon discounted the worst, and a long "line" of accumulation appeared during the first half of that year. Towards the end of 1885 a series of upward zig-zags suggested that a new bull market was in progress. That upturn predicted the general prosperity of 1885-86. Noyes quotes a contemporary as saying that 1886 was "...the best business year since 1880."

During 1887 and 1888 an extended decline occurred, and readers may elect to call this a reaction or a mild bear market. In 1888 a market advance began which continued to 1890. Of 1889, Noyes writes that it "...surpassed all predecessor in volume of trade movement."

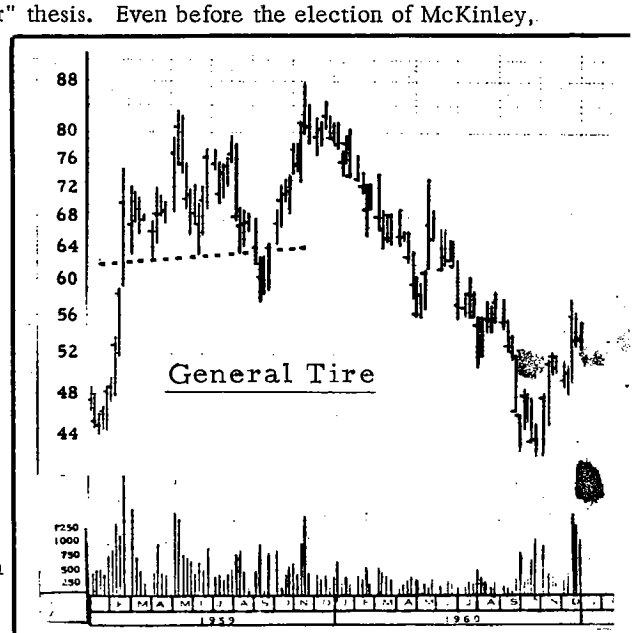
In 1890 the Argentinian market collapsed, the powerful British house of Baring was caught in a series of defaults and the "Baring Panic" was on. This precipitated British selling on the N. Y. Exchange, followed by a panic which saw call money rise to 186%. In 1891 gold began to leave U. S. shores in staggering sums. According to the U. S. Treasurer, "By the end of June (1890) the export of gold had reached the unexampled figure of 70 million dollars for the six months!" Noyes's account of the gold outflow sounds painfully familiar today: "In 1891, as usually happens when an inflated currency begins its work of mischief, any explanation of the gold flight was received except the most plain and obvious. The Government reports explained that the national banks of England, France and Russia had reasons for wishing to increase gold reserves; that American tourists had been spending more gold abroad than usual because of the Paris Exposition, etc."

Although the market had flattened out from late 1891 to early 1893, it is interesting to note that it could not better its previous high of 1890. In 1893 the bear market turned into a panic marked by the bankruptcies of the Phila. & Reading R. R. and the Nat. Cordage Co. A run on the banks developed and 224 banks were forced to suspend payment.

A mild recovery set in during 1894-95. Due to crop damage, commodity prices began rising in early '95, and the speculation spilled over into the stock market. Towards the end of that year Europeans began cashing in their commodity and stock profits while withdrawing gold. In the next few months 65 million in golds was withdrawn. In December, 1895, Cleveland saw fit to rebuke England, talk of war was rife, and conditions generally worsened. During early 1896 capital was in flight from this country, call money reached 125% and long lines of individuals stood outside the Treasury waiting to turn their dollars in for gold. That summer (1896) Bryan delivered the famous speech in which he accused Wall Street of crucifying the common man on a "Cross of Gold".

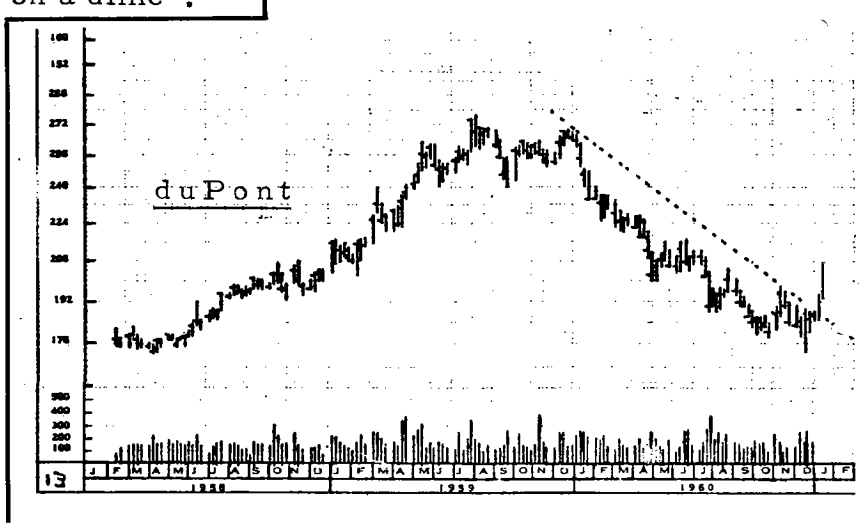
But the Republican McKinley stood fast on the gold standard, and the market turned up in mid-summer (1896), thus foreshadowing McKinley's election over Bryan and the continuance of the gold standard and stable money. When commodities firmed up prior to the election it was said that the farmers began questioning Bryan and his "free silver" thesis. Even before the election of McKinley, the great bull market of 1896-1900 had begun.

<u>STOCKS</u> The weekly chart shows duPont hitting its high in August, 1959, forming a double top in January, 1960, then "cracking" its intervening low point and plunging 88 points to a 1960 low of 178 3/4. Note that the long downward trendline has been penetrated on the current advance, and that despite the lack of a large base DD has rallied 27 1/2 points. The move in DD, judging from the massive top and the rather skimpy base, has all the earmarks of a rally in a primary downtrend. Interestingly enough, the 27 point rally in DD has been responsible for better than 12% of the rise in the Industrial Average since the 566 low point.



Charts courtesy of Traders Research
P. O. Box 6185, Lambert Airport, Mo.

The second chart shows a rather familiar phenomenon in this market. In 1959 General Tire (GY) formed a perfect "head-and-shoulders" top, then plunged through the support (dotted line). But at the low of the move, GY was aided by the violent upswing in the general market, and the stock "turned on a dime". By January GY actually touched a new high, and many a short had been forced to cover. Yet the appearance of a head-and-shoulders top almost always suggests important distribution, and when the technical strength had been run out of GY, it dropped precipitously (GY lost half its value in 1960).



(Written January 16th - 2 P.M.)

Note: New subscribers who would like a copy of the <u>50% Principle</u> may send large stamped seld-addressed envelope.

THE FIRST DOW-JONES AVERAGES
1885-1896

The present Dow-Jones industrial and railroad averages are generally considered as dating from January 2, 1897. However, during the period 1885 to 1896, four different averages were computed by Dow-Jones & Co. They were:

(1) An average of 14 stocks
Feb. 16, 1885-Dec. 31, 1885

(2) An average of 12 stocks
Jan. 2, 1886-May 25, 1896

(3) An average of 12 industrial stocks
May 26, 1896-Dec. 31, 1896

(4) An average of 20 stocks
Sept. 23, 1889-December 31, 1896

The earliest stock average computed of which any record is available was of closing prices on February 16, 1885. This average was made up of 12 railroad stocks and two industrials; it was computed daily until December 31, 1885. The stocks used were as follows:

Central Pacific	Louisville & Nashville
Cent R. R. of New Jersey	Missouri Pacific
Chic, Milwaukee & St. Paul	New York Central
Chicago Northwestern	Northern Pacific pfd.
Delaware & Hudson Canal	Pacific Mail Steamship
Del., Lackawanna & West.	Union Pacific
Lake Shore Railroad	Western Union

Beginning January 2nd, 1886, this average was replaced by an average of 12 stocks, 10 of which were railroads and two industrials. The 12 mixed stock average was computed until May 25, 1896. The original list of stocks, which was not changed until April 9, 1894, consisted of:

Chic., Milwaukee & St. Paul	Missouri Pacific
Chicago Northwestern	Northern Pacific pref.
Delaware & Hudson Canal	New York Central
Del., Lack. & Western	Union Pacific
Lake Shore Railroad	Pacific Mail Steamship
Louisville & Nashville	Western Union

On April 9, 1894, the following substitutions were made:

Deleted from average:	Additions to average:
Lake Shore Railroad	Chic., Burlington & Quincy
New York Central	Chic., Rock Island & Pacific
Pacific Mail Steamship	American Sugar

The 12 mixed stock average was compiled for the last time at the close, May 25, 1896. On May 26, 1896, Dow-Jones for the first time computed an average consisting entirely of industrial stocks. The new average contained 12 stocks. May 26,1896, therefore, marks the beginning of the present Dow-Jones industrial average.

The original stocks contained in the industrial average were:

American Cotton Oil	Laclede Gas
American Sugar	National Lead
American Tobacco	North American
Chicago Gas	Tenn. Coal & Iron
Distilling & Cattle Feeding	U. S. Leather pref.
General Electric	U. S. Rubber

The first average computed from this list of stocks was 40.94. It declined gradually during June and July and on August 8, 1896, stood at 28.48, which is the lowest point on record for the Dow-Jones industrial average.

On August 26, 1896, Distilling & Cattle Feeding became American Spirits Manufacturing and U. S. Cordage pref. was substituted for North American.

On November 10, 1896, Pacific Mail Steamship was substituted for U. S. Rubber and on December 23, 1896, Standard Rope & Twine was substituted for U. S. Cordage pref. The list of stocks was then the same as on the following January 2 when the more recent history of the averages begins.

While the average of 12 mixed stocks was still being computed, another average had been started. This average was made up of 18 railroad stocks and two industrials. Persons who are interested in extending the present Dow-Jones averages backward as far as possible can consider this the beginning of the present railroad average, provided they bear in mind that until October 26, 1896, there were two industrial stocks in the average.

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